DBF GUIDANCE FOR GEORGIA STATE-CHARTERED BANKS, BANK HOLDING COMPANIES, CREDIT UNIONS, AND TRUST COMPANIES

TO: Supervision Staff

CC: Georgia State-Chartered Banks and Credit Unions

FROM: Melissa Sneed
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SUBJECT: ASSESSING LIQUIDITY IN COMMUNITY FINANCIAL INSTITUTIONS

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Effective liquidity risk management is essential for the safety and soundness of financial institutions. The increased use of noncore funding strategies can result in increased complexity that requires more sophisticated liquidity oversight. Cash flow projections, diversified funding sources, unencumbered assets, well-developed contingency funding plans, and stress testing are all key components for managing liquidity. The Board of Directors is expected to require its management team to implement appropriate measuring, monitoring, and reporting systems commensurate with the risk profile of the institution.

Determining liquidity adequacy requires an analysis of the current liquidity position, which includes the level of cash and cash equivalents, the impact of asset quality, present and future earnings capacity, historical funding requirements, anticipated funding needs, and options for reducing funding needs or obtaining additional funds. Historical funding needs include understanding retention rates for all deposits as well as seasonal, peak, and average cash letter funding needs. Consideration should be given to public funds and other large depositors for deposit runoff from expected uses, such as sinking fund payments or other planned departure from the institution. Liquidity adequacy should ensure the institution's ability to access cash as needed at a reasonable cost.

Liquidity Ratio and Cash Flow Analysis

The liquidity ratio is a static balance sheet measurement that depicts a point-in-time measure comparing potentially liquid assets to total deposits and borrowings. This ratio provides general insight into the institution's liquidity status but does not consider possible funding needs or

changes in the availability of liquid assets over a period of time. The Department is concerned that the liquidity ratio may not be a sufficiently precise tool for institutions to appropriately control liquidity risk when liquidity levels are low, the asset size of the institution warrants more robust measurement techniques, and/or the institution has a complex funding structure. These institutions will be better served by adoption of robust cash flow monitoring, which can consider liquidity issues over multiple time horizons and can take into account the amount and timing of both sources and uses of funds. An institution's liquidity monitoring must provide assurances that cash letter requirements will be met.

Cash flow projections that include discrete and cumulative cash flow mismatches or gaps over specified future time horizons under both expected and adverse business conditions are essential for cash flow analysis. Typically, cumulative time buckets measured may include overnight, 5 days, 10 days, 30 days, 60 days, and 90 days for funding sources and uses. Funding sources include loan collections, investment collections, investment/asset sales, fee income, and deposits. An institution may find that splitting out local (retail) deposits, deposits garnering more than 75 bps of the national rate cap (de facto brokered), Internet, and deposits obtained through brokers to be useful for planning and stress testing. Funding uses include loan originations, scheduled investment/asset purchases, operating and interest expenses, funding standby letters of credit, and deposit runoff. Also, a cash flow match should capture institution-specific strategic initiatives, such as large cash outlays and deposit campaigns.

The Department has observed that there are certain levels of on-balance sheet liquidity below which an institution (in satisfactory condition) may begin to experience problems in meeting its day-to-day liquidity requirements including cash letter requirements, deposit withdrawals, and lending requests. The Department has observed that once on-balance sheet liquidity drops below 10%, such problems may become more prevalent, particularly if secondary sources of liquidity are unexpectedly unavailable to provide liquidity support. While this level of on-balance sheet liquidity is not an absolute minimum requirement, management has a regulatory hurdle to overcome to satisfy liquidity adequacy. When on-balance sheet liquidity drops below 10%, the Department may require an institution to provide detailed cash flow information to assess the level of supervisory concern. The request may result in no further reporting or periodic reporting, such as daily, weekly, monthly, or quarterly.

Liquidity Resources

On-balance sheet liquidity represents cash and unencumbered assets that are readily convertible to cash on an immediate basis. The sum of these assets divided by the deposit liabilities, short-term borrowings, and other non-depository sources of funding, which are due within one year, results in the liquidity ratio. Loans that are on-balance sheet or are in the "pipeline" and immediately and readily available to be sold, are included in on-balance sheet liquidity, and other loans may be a source of contingency funding that can be arranged over a few days.

Noncore funding sources may include deposits originating outside of the financial institution's trade area; however, these deposits may be restricted under certain conditions. Additionally, if the overall condition of the financial institution is deteriorating or if the risk profile of the financial institution is increasing, carefully consider the impact of changes in permissibility of

these resources on liquidity projections and planning, including potential runoff of uninsured deposits.

Off-balance sheet liquidity, or secondary sources of liquidity, may or may not require collateral. These sources include readily available lines of credit with correspondent institutions, Federal Home Loan Bank (FHLB), or the Federal Reserve Bank only if all steps have been taken for immediate access. Also, if certain institution assets are encumbered by drawing on these secondary lines, such as loans or securities, then the institution must ensure that these resources are not double counted in its calculations. Some secured lines of credit require a few days to settle, which should also be considered by management. Institutions should carefully review all contracts with providers of secondary sources of liquidity to ensure that access will not be restricted during a genuine emergency. The Department has noted that many contracts allow the issuer of the line of credit to cancel at will and with no warning to the institution. Other contracts may restrict the time that borrowings under a line of credit may be outstanding, which could be problematic for an institution with the need to borrow funds for longer periods of time.

Contingency Funding and Stress Testing

Contingency funding plans should outline specific steps, in order of expectation of use, if an unexpected liquidity need arises. Additionally, the plan should include stress testing that considers the impact of the loss of liquidity sources from a planned liquidity resource. Loss of liquidity sources may be a result of the deteriorating condition of a financial institution, where it is not unusual for correspondent fund resources to be materially reduced and/or require security if previously unsecured. Certain funding resources, such as the FHLB, have access to sensitive information that can result in borrowing lines being frozen, with the expectation of curtailment, or simply reduced. If the financial institution has borrowings, compliance with the covenants associated with those borrowings should be monitored.

Additionally, vendor oversight should consider the financial condition of correspondents to determine if the provider will be able to meet obligations in a crisis. The provider may have overcommitted to provide funding or be in a deteriorating condition. In either case, lines of credit may be reduced with little notice. Regular testing of secondary lines of credit should also be performed by the institution.

Dependency on Volatile Funding and the Potential Impact to Liquidity Resources

Non-core Funding Dependence is generally a measure of the degree of reliance on volatile funding. Volatile funds are generally resources outside of retail deposits in the local trade area, for example, Internet deposits, brokered deposits, correspondent financial institution funding, uninsured deposits, deposits above 75 basis points of the FDIC national rate cap, and other borrowings. In certain situations, deposits such as reciprocal CDARS, uninsured deposits, and deposits outside of the local trade area defined as volatile may have attributes of core funding relationships when evaluating factors such as multiple renewals, multiple loan and deposit relationships, shareholder relationships, etc. It is incumbent upon management to accurately support and maintain ongoing reporting if non-core funding dependence ratios are adjusted for core funding considerations in addition to calculating regulatory defined dependency ratios.

A high level of dependency can indicate a need for additional on-balance sheet liquidity and may result in the Department requiring regular reporting to assess the level of supervisory concern. Moreover, dependency on volatile funding sources typically weakens the franchise value of a financial institution, which can significantly limit capital raising options. The composition of the non-core liabilities, investments, and long-term assets should also be considered when determining if the dependency level is acceptable or excessive. If non-core liabilities consist primarily of brokered deposits and capital levels are falling, then the Board oversight should be increased due to federal brokered deposit restrictions.

Deposits that meet the federal definition of a brokered deposit may not be available to be accepted, renewed, or rolled over when a financial institution falls below the "well capitalized" PCA category, which can result from capital ratios dropping below established benchmarks, regulatory determinations resulting from administrative actions, or other notification from the federal regulator. Institutions that fall below "adequately capitalized" are prohibited by FDIC regulation from accepting, renewing, or rolling over any brokered deposits. Deposits generated outside the local trade area and through listing services meet the FDIC definition of brokered deposits if rates exceed the FDIC determined national rate cap by 75 basis points as well as deposits originated by brokers. Banks operating in a high market rate environment may qualify for a different calculation, but formal correspondence must be obtained by the FDIC. Management should have access to adequate information systems and understand the implications of rate limitations to build appropriate management monitoring and planning reports.

Internal Controls

An institution's internal controls consist of procedures, approval processes, reconciliations, reviews, and other mechanisms designed to provide assurance that the institution manages liquidity risk consistent with board-approved policy. Appropriate internal controls should address relevant elements of the risk management process.

Management should ensure that an independent party regularly reviews and evaluates the various components of the institution's liquidity risk management process. These reviews should assess the extent to which the institution's liquidity risk management complies with both supervisory guidance and industry sound practices, considering the level of sophistication and complexity of the institution's risk profile.

Additional guidance on liquidity is addressed in the March 17, 2010 Interagency Policy Statement on Funding and Liquidity Risk Management.